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Ashima Goyal

Indira Gandhi Institute of Development Research

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Reform Proposals from Developing Asia: Finding a Win-win Strategy

Ashima Goyal

Professor

Indira Gandhi Institute of Development Research

Gen. Vaidya Marg, Santosh Nagar,

Goregaon (E), Mumbai-400 065

ashima @ igidr.ac.in

Tel.: +91-022-28400920 (EPABX), Fax: +91-022- 28402752

<http://www.igidr.ac.in/~ashima.htm>

Abstract

Recipient countries and creditors have different perspectives on proposals for reform of the international financial architecture. The difference arises from varying perceptions of the causes of the East Asian crisis. Creditors emphasize inappropriate policies of borrowing countries, and inadequacies in financial sectors. Recipient countries point to evidence of incorrect monetary policy advice, of contagion and herd behavior. If reforms include items from both sets this would maximize future benefits from financial flows. Statements from Asian policy makers and academics indicate that these countries remain committed to globalization and financial reform and are willing to adopt policies from the first set. If the balance of global power allows creditors to escape policies from the second set, it will harm them in the long run. Greater understanding of these technical aspects, stronger Asian regional groups and coalitions with other reformist groups and academics increase the chances of a more balanced set of reforms.

Key words: International financial architecture, East Asian crisis, creditor view, debtor view, balanced reform, crisis warning

JEL classification nos.: F33, F36, F53

INTRODUCTION

The repeated financial crises of the 1990s have driven home the point that the structure of the international financial system is not satisfactory. An ideal new international financial architecture should reduce the frequency of crises, or eliminate them totally. If they occur, they should be resolved quickly, and without contagion. The new international financial architecture also has to be feasible.

As East Asia recovers rapidly from the 1997-1999 crisis, it remains deeply committed to globalization. Governments are serious about restructuring, improving regulations, corporate governance, and keeping a balance in macroeconomic policies so as to discourage bubbles, but stimulate recovery. They want to reform, not merely to prevent future crises, but because they think that will help them to perform well in the future.

Even so, proposals for reform of the international financial architecture can be divided into those favored by creditors and those favored by recipients. The former set is valid if crises of the 1990s were due to inappropriate policies of borrowing countries. But incorrect post-crisis monetary policy advice, contagion, and herd behavior of investors also magnified the crises. Another set of reforms is required to minimize these in the future. These are also on the Asian agenda. Asians are conservative and therefore largely follow the emerging global consensus, which reflects the creditor view, on the causes of the Asian crisis and the best preventive measures. The additional items on the Asian agenda also can affect outcomes if a critical coalition of supporters is formed and pragmatic domestic and international policies give united Asian leaders international bargaining strength.

Private financial interests resists input from emerging market countries in a well-organized coalition. Yet most of the proposals on the Asian financial reform agenda would benefit creditor as well as borrower interests. The disputed items on the Asian agenda are

transparency requirements for transnational private investors; debt workouts that bail in private capital; steps for faster and easier international debt restructuring; freedom to use market-based controls on short-term capital flows if necessary; regional initiatives for liquidity support; managed exchange rates; and recognizing that good macroeconomic policy has to be context sensitive. Asian countries are willing to adopt legal and financial reforms in banks, bonds, and equity markets that creditors are keen on. If some of the items on the Asian agenda are included, it will make for a more balanced set of reforms, and therefore a more stable financial system. This would allow an expansion of capital flows, and offer more opportunities for creditors and nations.

I. TWO VIEWS OF INTERNATIONAL FINANCIAL REFORM: THE CREDITOR VIEW AND THE EVOLVING ASIAN POSITION

At the risk of some simplification, there are two broad views on necessary reforms of the global financial architecture. The first would attribute the crisis to actions or weak institutions of capital-importing countries, and implies that penal provisions are necessary to prevent such mistakes in the future. Moreover, "sound" macroeconomic policies will ensure the safety of international capital and minimize the contagion risk for neighbors. Countries should not try to pursue unsustainable high growth. Lending organizations, home governments of the major private transnational financial institutions, and defenders of the interests of foreign capital hold views that fit in the first group. Academics who are convinced that the free movement of global capital improves the allocation of resources and imposes beneficial discipline on borrowing countries also adhere to this view (Meltzre 1998; Parikh and Shah 1999).¹ Most advanced industrial country governments, international organizations such as the International Monetary Fund (IMF), and interest-group-associated think tanks such as the private sector Institute for International Finance (IIF) also espouse the creditor consensus (IIF 1999; IMF 2000c). The U.S. Treasury Department strongly advocates the free movement of capital (Summers 2000). Although the G7

usually endorses the creditor consensus, Japan, because of crosscutting regional affiliations, sometimes does not.

A second view would blame international financial crises on contagion or the herd mentality of foreign investors. If funds make losses in one country, then they are forced to make good by pulling out in others; since dedicated funds service developing countries, contagion occurs. Creditors, following one another out in a rush to escape a crisis, make it worse. Then currency and banking crises reinforce each other. This alternative view suggests that support for borrowing countries is required for them to be able to brave the turbulence of international financial waters. Policymakers in developing countries that are large net borrowers and in countries that have been afflicted by currency or debt crises take the second view (Kin 2000; Hayami 2000; Hussin 1999; Reddy 2000; Sakakiabara 1999). There are, of course, differences among developing countries. Academics located in both advanced industrial and developing countries who believe that some measures are required to prevent ill effects from high short-term capital mobility share some aspects of the developing country position (Eichengreen 1999; Bergsten 2000; Rose 1999; Stiglitz 1999). Extremists argue that the only alternatives left are either free capital flows -with or without an international lender of the last resort - or complete controls on capital movements, but the majority believe that only something in between is feasible. Thus while the creditor position is closest to the "laissez-faire liberalizers" (see the chapter by Leslie Elliott Armijo) developing countries are both "financial stabilizers" and "transparency advocates," with the emphasis on the first. "Anti-globalizers" are a minority with very little influence in Asia.

Support for specific proposals on the new international financial architecture can largely be predicted by membership in one of our two groups. There is agreement on the potential benefits of foreign inflows, but there are differences over the domestic policies and new international norms required to make inflows safer and to raise their productivity. Sometimes the differences lie only in the specifics and the emphasis. In general, the reforms creditors favor are

acceptance and implementation of international standards of good practice in financial sectors and macroeconomic policy. A report prepared after intensive discussions among fourteen Asian countries (APF 2000) reflects the Asian viewpoint. Among the items listed for countries with capital account convertibility are a managed exchange rate and market-based capital controls to deal with massive capital inflows; strengthening prudential regulation and supervision of financial institutions and developing domestic capital markets to prevent crises; and measures to effectively manage a sudden reversal of capital flows. The first proposed measure is "bailing in" the private sector to ensure that private creditors are involved in the resolution of crises. Second, the report recommends options such as debt-equity swaps, or standstills, collective representation of creditors, and majority action to alter payment terms of contracts to allow quick, orderly debt restructuring. Third, special borrowing facilities such as contingency credit lines should be made available in times of crises; these can be complemented by regional financial arrangements with effective surveillance and conditionality. Fourth, the report proposes restricting holdings of local currency by nonresidents to discourage offshore markets that lower the effectiveness of monetary policy. For countries with relatively closed capital accounts the authors suggest a careful sequencing of reform.

Crucial suggested reforms of the world's financial architecture can be classified into a) new rules and procedures with better risk-management and incentive properties (including transparency and reporting requirements, provision of bankruptcy option, and capital controls); b) reform of the IMF; and c) changing the conduct of domestic monetary policy in capital-importing countries. I discuss these options in turn, emphasizing the differences between the dominant creditor view and the emerging Asian position.

A. Transparency and Reporting Requirements

There is general agreement that banks, bond, equity, and foreign exchange markets should be strengthened through deepening, modernization, and prudential regulation. This would reduce incentives for unhedged foreign short-term borrowing. Both private firms and financial institutions should implement adequate risk management systems. If capital flows were based on easily available and up-to-date information, then risk assessment would improve, and the chances of a panic would be reduced. There is broad international support for measures currently being taken to increase detail in public and private collection of data, reduce lags, and make data more accessible and interpretable (G22, 1998). A number of proposals have been made for setting up new international bureaucracies for regulation and supervision (see Eichengreen 1999), but the consensus seems to be that none of these are feasible at present because of conflicts of interest between countries or with existing institutions. Disagreements about transparency and reporting requirements are only over the degree of inclusiveness.

Private financial institutions want even more stringent transparency and accounting standards for developing countries than the IMF has imposed. For example, the Institute of International Finance(IIF), an association of 315 private multinational banks and institutional investors, is not satisfied with the transparency standards set by the IMF, especially in the area of external debt and reserves. The IIF's emerging market benchmark standards require weekly, rather than monthly, data on official reserves, as well as data on the disposition of and drains on reserves. It is not satisfied with simple data provision; but wants the data put in the context of the evolution of policy and economic performance through active Investor Relations Programs, and also wants the data used to strengthen risk management (IIF 1999).

Recipient countries, however, would like similar requirements imposed on hedge funds, and stricter surveillance not only for emerging markets, but also for developed countries and offshore financial centers.² Large investors should make their movements public. Korean President Kim Dae-jung (2000) proposed that a hedge fund monitoring channel be established at an appropriate multilateral institution, since ready exchange of information on the investment

activities of highly leveraged financial institutions (including investment banks) would contribute to the stability of international financial markets. Current scrutiny and surveillance are not adequate because regulatory structures have lagged behind the increasing sophistication of financial instruments. Regulators have to find innovative way to make institutions and markets reveal more information. Y. Venugopal Reddy (2000), deputy governor of the Indian Reserve Bank, points out that surveillance is more frequent and intense for developing countries, yet in recent experience sources of instability have arisen in developed countries as well. Indian Finance Minister Yashwant Sinha (2000) recommends that codes not be so demanding that they degenerate into an exercise in labeling countries as performers and non-performers, and that such codes should be applied equally to all member countries. Regulation has to be tailored to the circumstances and supervisory capabilities in developing countries (Stiglitz and Bhattacharya 1999). In some cases a lot of institution building is required; in others it is possible to jump to best practices.

Events and announcements confirm these attitudes. As the affected Asian countries have made a good recovery from the crisis, they want to resume their earlier rapid gains from globalization, which they regard as inevitable. The economies of the members of the Association of Southeast Asian Nations (ASEAN) grew 4.4 percent in 1999, compared to a contraction of 4.6 percent in 1998 (ASEAN 2000). They want to develop the human resources required to make full use of the information technology boom,³ participate in the new global order, and to acquire modern institutions, standards, and regulations that will lower their risk of doing so. At their meeting in March, ASEAN finance ministers decided to take active measures to restore private foreign investment, strengthen corporate governance practices; and deepen and develop ASEAN's capital and bond markets in order to improve risk management (ASEAN 2000). Korea, which traditionally had not encouraged foreign direct investment, now welcomes it. The point is that countries want to reform, not only because of the crisis, but in order to grow rapidly. The aftermath of the crisis has left a stronger determination to remove all poverty in Asia.

Chinese policymakers believe that China escaped the crisis because of its controls over capital flows, foreign exchange and financial markets administrative reform, and steps taken to control inflation, overheating and bubbles since mid-1993.⁴ These measures resulted in a successful soft landing in 1997. After that domestic interest rates were aligned to international rates. Keeping the renminbi stable contributed to the resolution of the Asian crisis. But China also wants to move towards more market-determined rather than government determined systems as the way to modernize. Chinese analysts worry about the low efficiency of state-owned enterprises and their extensive funding from public sector banks.

India is also all for the adoption of transparency practices, core principles and codes, but policymakers point out that there must be flexibility to allow for differences in economic structure across countries, and the development of the appropriate institutional, technological and legal infrastructure. In as much as both financial market infrastructure and the overall level of development are higher in East than South Asia, Indian policymakers argue that the latter has to be brought to the required level of sophistication before fuller opening out to capital flows is possible (Reddy, 2000).

Still the creditor view has dominated, since the general consensus seems to be that the hard-hit countries themselves were to blame. The allegations of crony capitalism and under-regulation of the financial sectors in these countries have some truth to them, but undervalue the steady financial sector reforms and modernization that had been undertaken since the eighties (White, 1994). In Malaysia, for example, the first rating agency was incorporated in 1990, the Securities Commission was set up as regulator in 1993, and the Kuala Lumpur Options and Financial Futures Exchange, which provides hedging services, became operational in 1995. The Philippines has also significantly reformed its financial sector in the 1990s. Moreover, it is not clear that conventional practices were entirely a symptom of corruption. Even Cole and Slade (1998), who take the creditor view, argue that the Indonesian crisis was as bad as it was primarily because of the collapse of the implicit guarantee the Suharto connection gave businesses

associated with the ruling family. Snowden (1999), however, points out that family and other extralegal connections historically have been a way of moderating special risks in developing countries. They lower problems of asymmetric information that are pervasive in financial transactions.

B. Liquidity Support, Bankruptcy Procedures, and Bailing In Creditors

Analysts associated with what I have termed the "creditor view" argue that bankruptcy procedures would merely raise the spread and cost of borrowing for developing countries, and private capital would exit even faster. For example, Stanley Fischer writes, "The more certain it is that the private sector will be bailed in, in a compulsory way, the greater the incentive creditors will have to run--and this change will tend to produce more rather than fewer crises" (1999,575). The report of the G-7 finance ministers to the Koln Economic Summit of 1999, which was accepted by the IMF, suggested that compulsory private sector involvement be avoided. The balance of initiative is to lie with the country concerned, with the IMF to play its traditional catalytic role in cases of moderate indebtedness. Operational procedures for other cases are left unclear (IMF, 2000a).

The recipient country response is that such reforms lower the probability of crisis. Re-writing loan contracts to include bankruptcy clauses, as well as adding majority voting and sharing clauses, would prevent a few isolated creditors from holding up settlements that enhance the welfare of the majority. Collective representation clauses that appoint a trustee to represent and coordinate sovereign debt holders and creation of standing committees of creditors would encourage faster negotiations. The IMF could lend into arrears to indebted countries as long as they were involved in such good faith negotiations, thus keeping the economy running, even in a crisis. It could also declare a standstill, to protect a country from its creditors, while restructuring of debt takes place (Eichengreen, 1999).

Modern crises have struck currency and debt markets together. If a major cause of crises is traders and creditors following each other's actions, or competing to grab assets when countries default, then reforms can actually protect creditors from each other. Simple game-theoretic models, with two currency traders (Obstfeld 1996) or two creditors (Miller and Zhang 2000) illustrate this. First, consider currency traders. When reserves are low, traders will certainly attack a currency peg, since by selling the currency they will make money from the devaluation that follows. When reserves are high, they lose their transaction cost if they attack, since the government successfully defends the currency. Each game has a unique *Nash equilibrium*⁵ in which the payoff of each trader is maximized, no matter what the other does. In intermediate regimes, only if both attack together can they run down the government's reserves. The payoffs for this regime are shown in Table 1. If any one attacks alone the transaction cost is lost, for a payoff of (-1), while whoever holds gets zero. If both attack together (*sell, sell*) they get a positive payoff from sharing the government's currency reserves, and profit from the currency depreciation. The game changes to a coordination game with two Nash equilibria, which the arrows show. Now either both will hold the domestic currency or both will sell it. Herd behavior leads to self-fulfilling crises, where trader 1 attacks thinking that trader 2 is going to do so. In such a model higher availability of international reserves will allow the government to defeat the attack. Then *hold, hold* in the northwest corner, is again the Nash equilibrium. The policy conclusion is that a ready availability of international liquidity can prevent the category of crises that occur due to herd behavior, even when country fundamentals are good.

Table 1: Currency Speculation leading to a Coordination Game

		Trader 2	
Trader 1	Hold	Hold 0, 0	←
	Sell	↑ -1, 0	→ ↓ 1, 1

I turn next to the analysis of international debt. The holders of private or sovereign country debt face a Prisoner's Dilemma if a country becomes illiquid even though it is solvent. If both hang on (*hold, hold*) they maximize total welfare. If either one is able to grab assets she does the best for herself and the other is left with nothing. So both will try to *grab* assets. The firm is forced into premature liquidation or the country forced to devalue, assets fall in value, and both the creditors are worse off. Bankruptcy procedures which give equal treatment to creditors of the same seniority can make holding on the unique *Nash equilibria* since the first to grab no longer gains. Therefore both would play *hold*.

But in the presence of short-term debt, those who agree to roll it over would lose out compared to those who refuse, as liquid assets are equally divided on bankruptcy. Then instead of a Prisoner's Dilemma, with a unique equilibrium, we have a *coordination game* as in Table 1, with two *Nash equilibria*, since the payoffs are now different for the asymmetric strategies. Inefficient equilibria where both creditors grab, the country goes bankrupt, and all are worse off, can still occur. In such a case, a standstill, which gives protection against creditors, is required. Domestic bankruptcy laws in the United States have a provision for this. Even though bankruptcy laws lower the legal rights of individual creditors, they protect them because inter-creditor conflict poses the greatest risk to asset values (see Miller and Zhang 2000).

Now consider the role of the IMF. It can be forced to *bail out* creditors, because of the great damage that creditor *grab* can do. Table 2 depicts the actions, equilibria, and payoffs. The first number is the payoff to the creditor, the second to the debtor--that is, the country. Note that the payoffs are to the country, but the IMF takes the action. The face value of the debt is ten units, and the payoffs to the creditor are the fraction of the face value received. The payoffs to the country consist of earnings from the loan taken. Considering the first two columns of payoffs, the actions available to the creditor are to *rollover* the debt or to *grab* assets; the IMF either can *do nothing* or make emergency funds available under a *bail out*. As the arrows show there are two *Nash equilibria*, the first where there is debt *rollover* and the IMF does not have to take any

action, and the second if there is *grab* and *bailout*. But the unique *Subgame Perfect Nash Equilibrium* is (10,3) if the creditor has first mover advantage.

Table 2: Sovereign Debt, Bailouts and Standstills

		IMF/Debtor		
Creditor	Rollover	No action (8,5) ↑	↔	Bailout (8,5) ↓
	Grab	(4,0)	→	(10,3)
				→ Standstill (6,7)

If the creditor moves first to *grab*, the IMF is forced to *bail out*, because the outcome with no action (4,0) is so bad for both the creditor and the country. However, since the *bailout* involves a full guarantee for the creditor, the creditor in future will push loans without proper investigation or monitoring. Hence the probability of default will rise. To undertake *no action* is not credible for the IMF, and therefore the creditor will always *grab* whenever the debtor is unable to service debt, though the creditor may still be solvent. But if the rules of the game are changed so that if the creditor *grabs* the IMF can impose a *standstill*, then the creditor will prefer to *rollover* the debt. Forced to accept a debt reduction under a standstill, the creditor's payoff is relatively higher under a rollover. Now the unique Nash equilibrium is (8, 5), with the creditor *rolling over* the debt and the IMF *doing nothing*. As the country has basically sound fundamentals, the lengthening of debt service under the rollover will give it time to recover; both country and creditor are better off.

Therefore, if reforms that bail in creditors are adopted, the herd behavior that brings on self-fulfilling crises should be discouraged. Otherwise, since protection from crises can never be complete, there will be a loss of profit-making opportunities for capital and a lower inflow to developing countries. Even with bailout packages and other protective devices all parties involved in a crisis make large losses. Moreover, if a standstill kicks in as soon as a critical mass

of creditors are leaving, they will not be able to escape by leaving first, and therefore their incentives to leave will fall, not rise. Such reforms will also not raise the cost of borrowing for developing countries, or make it more difficult for them to get loans, if better monitoring and debtor selection lower the probability of default.

The last implies that cost of borrowing will rise only for countries with a poor record or prospects. Although creditors have not always in the past distinguished between "well-behaved" and "foolish" emerging market countries,⁶ this should change when they have to bear some penalty for not doing so. There is evidence that creditors push loans with inadequate analysis or monitoring. Incentive will rise both for recipients to follow good policies, and for creditors to do more careful selection and monitoring. The voluntary choice of policies creates "ownership" which makes them easier to implement. Externally imposed policy conditionalities lead to resistance, and have a poor record of success. Fernandez-Arias and Hausmann (1999), argue that bailing-in the private sector won't work unless "willingness to pay", which is the major issue in developing countries, is addressed. But Asian countries have a very good record of repaying debt. Reforms do not have to reinforce willingness to pay or enforcement, so much as the ability to pay or liquidity.

If these arguments are correct, and creditors will gain from bankruptcy procedures, rational creditors should be willing to adopt them. Why is there so much reluctance? There are two potential reasons. First, the probability of a future crisis is still discounted, despite the experience of the 1990s. Second, creditor psychology is such that instead of minimizing the expected value of crises losses, creditors are more concerned about the loss itself than the reduction in its probability. Therefore the higher bargaining clout of investing nations leads policy makers to give higher weight to creditors' losses in the case of crisis, compared to their gains from a strongly reduced probability of crises. They push to protect taxpayers in investing nations by ensuring they do not suffer a loss in case a crisis occurs. If this analysis is correct, then a loss in bargaining power could actually turn out to be beneficial to creditors.

C. Capital controls

Creditors argue that with today's technology capital controls of any kind are impossible to enforce. They have a high cost in terms of foregone capital, and few countries are willing to impose them. Proponents of these views note that many who have used capital controls, including both Chile and Malaysia, eventually have removed them voluntarily.

These conclusions can be challenged. Many developing-country economists have concluded that a tax on short-term capital inflows can discourage the type of capital that is subject to herd behavior and decrease harmful excess volatility of these inflows (see also Cohen in this volume). Since technological change makes it difficult for regulators to keep up with financial institutions, a market-based tax on short-term capital flows can actually outperform discretionary prudential regulation (Ocampo, 1999). Developing countries have few policy-instruments that they can use to restrain cycles; therefore countercyclical short-term taxes serve a useful double purpose. More drastic controls on outflows may be required in times of crisis.

In Chile in the 1990s all non-equity foreign capital had to make a one-year, non-interest bearing deposit. The implicit tax therefore declined with the duration of the investment. This measure succeeded in lengthening the maturity structure of foreign debt, after it was made sufficiently comprehensive so as to plug major loopholes (Agosin and Ffrench-Davis, 1999). The ability of private agents to design loopholes and the costly and invasive monitoring sometimes required to close them, are the weakness of such taxes. Therefore they need to be used along with improvements in regulation and bank's own risk-management practices, and can be discontinued when the regulatory framework is strong enough, or if more capital is needed. Chile lifted its capital taxes in 1998, partly for these reasons. Malaysia introduced exchange controls and other measures in September, 1998, partly to eliminate trading of the ringgit in offshore markets (APF 2000). It controlled the transfer of funds in the external accounts, fixed the nominal exchange rate, and introduced a twelve-month rule to discourage short-term capital flows. These policies allowed it to

lower interest rates and revive economic activity. The measures were gradually relaxed as conditions improved.

International, or failing that, regional, agreements make capital-taxes easier to use. There are higher costs for one country to do it alone. It is difficult to tax a mobile factor of production, and capital mobility is now higher than that of labor. This is eroding the postwar liberal compromise whereby expenditures on social welfare were paid by taxes on capital in return for industrial peace (Armijo, 2000). In post-crisis countries the demands for such expenditure are rising. Coordinated taxes on short-term capital provide one answer to this dilemma. To some extent, the old conflict between labor and capital becomes less acute if the tax funds human resource and skill development, which improve returns to capital.

Although all countries accepted the possibility of using capital controls, at least temporarily, just after the East Asian crisis, nations in which creditor interests dominate are more doubtful about the measure. The group of seven includes Western developed nations and Japan. According to Eisuke Sakakibara, Japanese vice-Minister of finance during the Asian crisis, the G7 advocated a middle-of-the-road position, with which Japan agreed fully. Sakakibara observes, "It has sometimes been suggested by the press and others that Japan is advocating more controls on capital flows while other G7 countries are arguing for free capital movements. This is simply not true. ...Japan's position from the outset was that maintaining market-friendly controls that would prevent turbulent capital inflows should be justified when a country wants to keep capital inflows at a manageable level according to the stage of development of its financial sector, and that there might be some cases that would justify the reintroduction of controls on capital outflows as an exception, for example, in order to avoid a bail-out by IMF loans...[T]his stance...is shared by all G7 countries" (1999, n.p.). But Sakakibara also feels the need to emphasize the costs of capital controls, a point the collective G7 report emphasizes. He continues, "Such steps may carry costs and should not in any case be used as a substitute for reform..

[C]ontrols on capital flows can carry even greater long-term costs...although they may be necessary in certain exceptional circumstances" (1999, n.p.).

The argument that technological changes make controls on short-term capital at best infeasible and at worst inefficient is not borne out by the experiences of Chile, Columbia, Malaysia, India and China, all countries have successfully used partial (prudential) or more complete controls either as a short or long-term measure. There is a consensus that market-based and need-based controls work better; and they do impose a cost.

D. Reform of the IMF

The so-called Bretton Woods institutions were set up in the aftermath of the Great Depression, with the mandate to safeguard global economic interactions.⁷ One of the objectives of the International Monetary Fund, as laid down in Article I of its Articles of Agreement, is "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity" (Article I (v), see Fischer, 1999, pp. F571). Thus special help is mandated for countries in times of crisis. The functioning has been criticized but the need for such aid and the validity of the objective remains. All agree that the IMF will continue to be necessary, but will require serious reform to reflect the changes in the regime of global capital flows. The severity, frequency, and contagion effects of recent financial crises have exposed the inadequacy of the IMF's resources. In both the Mexican and East Asian Crises it had to draw upon other bilateral and multilateral sources. Although it is not a world central bank, since it does not have the ability to create money, it is often called upon to serve as an international lender of the last resort (LLR), but with funds that are puny compared to private capital flows.

The perspective of one influential group among the creditors is not that the IMF does too little too late, but that it does too much. The main problem for this group is the moral hazard for countries

induced by indiscriminate bailout packages. If countries know that they will be rescued from a crisis, then they will not take adequate preventive measures. The Meltzer Committee's recommendations to the United States Congress in early 1999 (see Bergsten in this volume), include narrowly focusing the IMF on international lender of last resort functions, and the abolition of its developmental functions as well as the special funds made available to developing countries. Many of these activities, it is argued, should devolve to the private sector. Moreover, lender of the last resort funds should be made available only to countries that prequalify with a strict set of capital markets and fiscal-policy-based criteria. Conditionality thus would be *ex-ante* rather than *ex-post*.

Developing countries have a radically different viewpoint. They want faster response time and larger availability of funds. For example, developing countries have long demanded that the Fund be allowed to issue Special Drawing Rights (SDRs), the IMF's own "currency," to itself (Ocampo 1999; Sinha 2000). This option would make funds available faster, as required, without a permanent increase in unconditional liquidity. The consensus is that some competition, more transparency, help from the private sector, and more focused developmental activities will improve the functioning of the IMF. Recently, the Japanese government and many Asian policymakers suggested a competing Asian Monetary Fund (see Laurence in this volume). In any event, many Asian scholars and policymakers argue that prescribing medication effective in old-style crisis of the current account will not do when today's crises originate in the capital account (Sakakiabara, 1999). Conditionality should be more context sensitive.

Unsurprisingly, the reforms that have been carried out so far at the IMF reflect the dominance of the main creditor countries. The Supplementary Reserve Facility (SRF) was introduced at the end of 1997 and the Contingent Credit Line (CCL) in April 1999. Both make large short-term loans, at penalty rates, to crisis-struck countries satisfying policy conditionality. The CCL can be used in a preventive mode, to reward good policies. These new facilities are pushing the IMF towards the international lender of last resort role, thus preventing loss to global capital, but still ignoring the other cardinal rule suggested by efficiency criteria: unstinting liquidity support. Bagehot

argued in his classic that central banks worsen crises when they lend "hesitatingly, reluctantly and with misgiving...In fact, to make large advances in this faltering way is to incur the evil of making them without obtaining the advantage" (Bagehot, 1873, quoted in Mayer, 1999, 6). Advances instead should be made freely but at a penal interest rate. When it is known that liquidity is available, the panic subsides. The new facilities made available do not meet these criteria. As Sinha (2000) points out, no country has availed itself of the CCL since its inception in 1999, implying that it does not meet the needs of borrowers. If no one uses it, how will it fulfil its role of crisis prevention? Special programs had been created for developing countries, which need longer-term structural adjustment. One such program, the Extended Structural Adjustment Facility (ESAF), was replaced in 1999 by the Poverty Reduction and Growth Facility (PRGF), which seeks to make recipient country governments more accountable and improve targeting.

The IMF reports to ministries of finance and central banks, and therefore reflects their views more than those of its shareholder countries as a whole (Stiglitz, 1999). Central bankers focus narrowly on stabilization and controlling inflation, yet the impact of such policies falls disproportionately on the poor. Within a country, democratic processes bring about a consensus among conflicting views and interests, so that national interests have a chance to dominate special or group interests (Stiglitz, 1999). But in the IMF the views of the different groups in its member countries do not get a full hearing, and democratic processes are skewed. Voting rights are proportional to the GDP of member countries, since these define contributions. The United States gets the largest vote, with near veto power in the Executive Board (Jha and Sagar 2000; Porter and Wood in this volume). With this structure it is difficult for the IMF to fulfill its objectives of representing a diverse set of national interests; these do not always coincide with those of the United States. Reforms that improve transparency and public accountability, and competition from regional funds that would check its natural monopoly, would therefore help the IMF to truly promote global interests. The other alternative is expanding liquidity available with the IMF and adjusting voting rights. One suggestion is to rebalance quota formulas, giving more weight to the size of the domestic

economy measured in purchasing power parity terms (Tobin 1998 and Jha and Sagar 2000). The quota formula could then determine country contributions, drawing power, and voting rights.

Even in the absence of harsh and one-size-fits-all external conditionalities, the developing country desire to leverage capital inflows is sufficient to force the countries to adopt conservative macropolicies, and global standards. Recent empirical studies have shown the ineffectiveness of World Bank *ex ante* policy conditionality (Gilbert, Powell and Vines 1999). Bank conditionality frequently created a conflict-based relationship with client governments that made reforms less successful than they might otherwise have been. An alternative approach being promoted is for the Bank to lend more to countries which follow good policies, and limit itself to spreading knowledge of what these good policies are in others. This is defined as *ex post* conditionality. Countries in charge of their own reform program would be better motivated to make it successful. They may form clubs that stimulate reforms of reciprocal benefit; there could be demonstration effects and regional spillovers. Low or less rigid conditionality facilities must be available when the imbalance is due to an international shock, or to contagion. Conditionality should be relaxed more automatically if conditions are worsen (Ocampo, 1999).

Many policymakers in recipient countries prefer this idea of participation by groups of countries, leading to greater policy "ownership."⁸ As private sector participation rises, and if there is effective bailing-in of the private sector, the market will charge lower rates to countries with better policies. Given the diversity among borrowers in macroeconomic conditions, which we discuss below, it is better that international lender of last resort conditions are partially conditioned on results, rather than on arbitrary or uniform preconditionalities. Another alternative, which lowers disincentives and was successfully used in Scandinavia, is to save the banks but not the owners. In order to minimize wealth transfers to original shareholders, in one case, the central government guaranteed all of a bank's obligations, except its equity (Mayer 1999).

Perhaps a competing Asian Monetary Fund would have a better understanding of the Asian context. Since the contagion that accompanies a crisis is often regional, a regional fund would be more active and involved. In effect the AMF would just replace the current ad hoc country groups that support IMF packages with bilateral aid; therefore there should be no conflict with the IMF (Rose, 1999).⁹ It would also save U.S. taxpayers money. A task force organized by the United Nations Economic Commission on Latin American and the Caribbean (ECLAC) sees the future IMF as the apex of a network of regional funds (Ocampo, 1999). Since in any case the IMF can no longer raise the kind of money required in current crises, its major role should be that of an honest broker in bringing debtors and creditors together and in the use of moral suasion, backed by its loans, to ensure the adoption of common standards. Surveillance by the AMF would be good because of its focused mandate and regional expertise, and as long as lending is with tough but context-sensitive conditionality, it would not lead to moral hazard.

In 1998 Argentina purchased liquidity insurance as a contingent repo option involving fourteen international banks. Such deals become more feasible if the IMF offers partial insurance cover for the collateral required. An IMF or World Bank guarantee reassures private creditors. It helps ensure repayment since debtors have a long-term relationship with these institutions. Private sector monitoring and funds then complement the IMF's efforts, and enhance liquidity available sufficiently to forestall crises. An AMF could complement such efforts for Asia. Because there is a first-mover disadvantage in, for example, redesigning debt contracts, the IMF has a major role in coordinating the simultaneous adoption of such measures. It is difficult for a country to adopt private sector bail-in policies unilaterally, since capital would then easily boycott it.

While the suggested reforms of the IMF can ensure fast action and appropriate conditionality, financial sector restructuring, tighter regulations, and the bailing-in of creditors can lower the moral hazard associated with crisis loans. Fast response is the key to effective liquidity support. Faster postcrisis program loans helped Korea and Thailand; Malaysia did not get this (perhaps because it was more independent in the reforms it chose) and private capital

flows also did not resume. Therefore it had a deeper contraction although its precrisis situation was better than that of the others (Cho and Rhee, 1999).

E. Macroeconomic and Exchange Rate Policies

Creditors advocate conservative fiscal and monetary policies to maintain the value of developing country currencies and allow integration with the global economy (Fischer, 1999). With respect to designing a crisis-free exchange rate policy, many suggest that the only two viable alternatives, given the extreme fluidity of global markets, are a completely free float or a fixed peg validated by a currency board or union. Otherwise a fixed peg is not credible and invites attack (Eichengreen 1999, 105). Mussa (IMF 2000b) maintains that a free float is not possible in developing economies because they do not have the deep foreign exchange markets that are required for a free float to be operational.

Capital recipient countries in contrast argue for balanced and pragmatic policies suited to local circumstances. As goals and conditions change, dynamic adjustments are required. With respect to exchange rate policy, many Asian economists and policymakers argue that only a managed float is both politically feasible and desirable (Bergsten 1998; Tobin 1998; RBI 1997), and would help to prevent crises (APF 2000). The main theme of a recent international conference organized by the Asian Development Bank Institute was to identify exchange rate regimes for developing economies that would fall between the two corner solutions (ADB, 2000).¹⁰ Managed exchange rates with sufficient two-way movement force all parties to hedge exposures, so that losses from sudden shocks do not become cumulative and intensify crises (Goyal 1999). This also frees monetary policy to adjust to the domestic cycle, to some extent.

There is an argument that since domestic banks cannot borrow long domestically or abroad in own currency, they have to borrow long in foreign currency. Therefore they cannot hedge, and a floating exchange rate will expose their maturity mismatch.¹¹ This reasoning is more valid for the Latin America, but in Asia domestic savings are relatively high, so that long-term

funds are available internally for domestic banks. As Stiglitz and Bhattacharya (1999, 117) write, "[W]ith its high savings rate, East Asia does not need a foreign supply of capital." Reform currently seeks to develop bond markets and pension funds. This will also make more long-term funds available. Moreover, even if natural hedges (by holding liabilities of similar maturities in multiple currencies) are not available, derivatives are, at a cost. If controlled two-way movements occur in exchange rates, open positions cancel out over time. Unhedged losses made on a net positive foreign currency balance when the nominal exchange rate appreciates, will be neutralized when it depreciates.

There is less agreement on interest rate policy, although it is recognized that this has to be very different in a regime of fast and free global capital movements. If exchange rates are kept fixed interest rates become more volatile; but interest rates have a larger macroeconomic impact, and it is easier to hedge against exchange rate volatility (Furman and Stiglitz 1999). It is important to distinguish between macro policies followed before and during crisis. The usefulness of raising interest rates in the course of a crisis is a separate analytical question from that of following systematic tight monetary policies so that domestic interest rates exceed international rates prior to a crisis. Currency crises in the 1990s were associated with financial or banking crises. The interest rate crisis defense was specially damaging in Asia because of high gearing and weak banks.¹² High domestic interest rates can defend the exchange rate only if country risk stays unchanged; but high interest rates can raise the latter and therefore lead to higher expected depreciation (Furman and Stiglitz 1999).

With respect to longer-term policies, it is argued that relatively higher interest rate regimes are required in developing countries, because capital is scarce and returns to investment projects are higher (Eichengreen 1999). But increased global capital mobility in the 1990s has modified this constraint. Long-term flows of private capital to emerging markets that were below \$50 billion in 1990 were at \$290 billion in 1997 (World Bank, 1998). Short-term flows and foreign exchange transactions are many magnitudes higher.

Under perfect capital mobility, monetary policy is not independent if exchange rates are fixed. With floating exchange rates, it is, but fiscal policy loses its effect. If there is a demand stimulus, interest rates rise above world interest rates and induce a capital inflow that appreciates the exchange rate until export demand is cut equivalently. But the problem is that the latter mechanism cannot be allowed to work in a developing country. Since high potential growth draws in net inflows, a floating exchange rate would appreciate and therefore harm exports, when stimulating them is a major objective for such countries. Although developing countries may be small in world export markets, they do compete intensively with each other. The capital account, influenced by expected future growth, now dominates the current account. Therefore current account adjustments can no longer ensure equilibrium.

There is a growing consensus that the exchange rate has to be managed, and monetary policy operational procedures in developing countries also have to focus on interest rates. Most major central banks worldwide now target a short-term interest rate as the best operating procedure of monetary control (Goyal 1997, 1999). Since the float cannot be total, monetary policy cannot be fully independent. Inflation can serve as a target to fix nominal expectations in lieu of a fixed exchange rate, but inflation is best lowered, in such countries, by policies that improve productivity and boost cost-effective supply. There are many administered prices, and with more openness the nominal exchange rate will also affect inflation.

If developing countries keep their domestic real interest rates as close to international rates as possible, it will stimulate their real economy. Capital will be attracted by higher profit rather than interest rates (Goyal 1999).¹³ As long as revenue deficits are contained, and productivity is rising on the supply-side, inflationary pressures will be contained. Smooth interest rates should discourage asset price volatility and deepen financial markets (Goyal and Dash 2000). China is an example of the successful use of this strategy. From 1997 to 1999, while countries around it raised interest rates sharply, interest rates on yuan-denominated assets in

China were close to those on dollar-denominated assets in the United States, showing a negligible risk premium. And there was no shortage of foreign investment flows.

Ideally a flexible exchange rate should give a country the freedom to vary the domestic interest rate procyclically, and smooth the business cycle. But in practice most countries seek to manage the exchange rate, when it fluctuates beyond acceptable limits, by raising domestic interest rates when the exchange rate is depreciating. But since this normally occurs in a business slump, it aggravates the depression. Therefore market-based cyclical capital controls offer a tool to manage fluctuations in exchange rates, and free the domestic interest rate for procyclical movements (Ocampo 1999), or alignment to lower international real interest rates (Goyal 1997). A well-designed exchange rate policy can achieve this purpose even without the use of controls.

The argument can be extended to developed countries also. Raising interest rates in order to attract or keep foreign capital is a "beggar-my-neighbor" policy and invites retaliation. Moreover, it is not always successful since raising interest rates can create expectation of rising inflation or currency depreciation even where these do not yet exist. The contributions of rising U.S. interest rates to the Latin American debt crisis of the eighties, and of U.S. Federal Reserve Bank rate cuts to nipping contagion from the Asian crisis in 1998, are well known. Short-term capital flows respond to changes in relative nominal interest rates. Since inflation rates are low worldwide, interest rates should show little variation in response to domestic needs, and not in order to defend exchange rates. This will discourage the less desirable volatile debt creating short-term capital flows. Real interest rates are converging internationally again. Obstfeld and Taylor (1997) show that interest rate arbitrage is working well in developed countries since the 1970; interest rate differentials are down to what they were in 1910. Global capital flows are forcing convergence of interest rates as capital flows to areas where interest rates are relatively higher; but emerging market countries still need to use policy to achieve this convergence.

Precrisis tight monetary policy was partly responsible for the East Asian crisis. Since nominal exchange rates were largely fixed, in a regime of capital inflows and tight monetary

policies, domestic interest rates exceeded international so that domestic financial institutions had an incentive to overborrow abroad (Goyal and Dash 1998; Furman and Stiglitz 1999). It cannot simultaneously be argued that the overborrowing by domestic institutions was due to weak regulations and crony capitalism, while overlending by foreign banks was due to higher interest rates--that is price incentives. If the tight regulations under which foreign banks operate did not prevent them from overlending, why will tighter regulations prevent developing country banks from overborrowing, if interest rate differentials induce them to do so? It follows that, in addition to lax regulations, responsibility for the crisis lay with the higher domestic, compared to foreign, interest rates in a regime of fixed exchange rates.

Turning to the crisis itself, most Asian policymakers agree that the macro conditionality imposed by IMF after the crises was incorrect. Austerity measures, designed for countries where crises were caused by large fiscal deficits were routinely applied to countries where government budgets were in surplus and conservative macroeconomic policies were being followed (Chang and Velasco 1999). The effect of the steep rise in interest rates in deepening the bankruptcies of highly geared private banks and firms was not foreseen. Most Asian countries later implemented lower interest rate regimes to stimulate demand and lower financial intermediation costs. In Korea, Thailand, and Malaysia interest rates were lower than precrisis levels by the end of 1998, as monetary policy was relaxed in the second half of the year. Malaysia introduced capital controls to allow it to lower interest rates when tight monetary policy failed to stabilize its exchange rate. China and India (Goyal and Dash 1998) lowered interest rates in the crisis period, which, together with capital controls, helped them escape the East Asian crisis.

Cho and Rhee, after reviewing postcrisis adjustments in the crisis-hit economies, argue that, "policy packages to be imposed on the crisis-hit countries will need to be better tuned to individual market circumstances. In economies such as Korea and Thailand, which are quite open, private sector oriented, and have a very high leverage ratio in the corporate sector, the sensitivity to a stabilization package could be higher than in other economies" (1993, 387). In

other words, such countries suffer more from a steep rise in interest rates. Meanwhile, Reddy (2000) articulates the Indian position: with respect to capital account convertibility and exchange rate regimes, one size cannot fit all--context and institutional sensitivity is required. Along with financial reforms, sustainable macrobalances need to be defined in the context of maintaining some national monetary and exchange rate policy autonomy under an open capital account. Proper sequencing of reform is another concern of policymakers. Financial liberalization too early can lead to harmful sharp peaks in interest rates. This has been documented for Africa (Collier and Gunning 1999) and Latin America in the 1980s.

The East Asian crisis has led to the realization that although in accounting and regulation uniform standards should be accepted, in macroeconomics there may be a case for acknowledging that good fundamentals are context sensitive. If financial capital comes to believe that some variation in good macroeconomic policies is justified, it will not panic at a slight deviation from a rigid norm. Capital flows are so large today that they can force obedience to expected norms, even if they are not optimal. This problem can be mitigated if countries are judged by results, not acontextual preconceptions of good policy. Better data availability needs to be supplemented with more country-specific analysis. Monetary policies have to find a fine balance between being too tight and too lax (Goyal 1997).

Asian economies are conservative and want to follow international best practices. Part of their problems arose from this Casablanca-style obedience. What is the best monetary and exchange rate policy is no longer so clear, in the new global regime of capital mobility. Academics, the IMF, and policy makers have to debate this and arrive at a consensus; this is a major current research area. Central Banks need guidance.

With the exception of Europe, all the currency crises of the 1990s involved developing economies. There is a tendency for capital to fly from what are regarded as "soft" currencies, at the least provocation, to "hard" currencies such as the dollar. Special features could be designed to make global capital markets safer for these countries.¹⁴ Donor countries also suffer from the

disruption, but if the NIFA only protects donor countries, developing countries will be forced to take other less efficient measures. Full Asian engagement with the global economy awaits reforms in the global financial architecture. Countries will be less inclined to adopt unilateral or group-based defensive measures if the new international financial architecture takes care of their concerns and provides stability, so that they have confidence in globalization.

The recovery in East Asia is largely following the V-shape observed after the Mexican crisis of 1994. The V-shape was not observed in the Latin American crisis in the 1980s, partly because it took much longer to negotiate rescue packages. The international community apparently has learned from the crises, since recovery was faster in the 1990s compared to what it was in the 1980. But, attention has to turn to measures of prevention in the light of experience. Although recovery is faster, the frequency of crises has also become greater-- so reforming the global financial architecture is of high priority. I now turn to the prospects for the Asian view influencing the global dialogue on financial reform.

2.NEGOTIATIONS: GIVING A LITTLE AND GAINING A LOT

The two positions explored above define the likely dialectics of the debate. Developing countries are willing to reform their financial sectors and adapt their monetary policies to international best practices. But many reforms they would like to see are stalled. Lender countries and interests dominate the international financial institutions. As a tightly organized interest group, they can better push their agenda compared to the more diffused group that is harmed by a financial crisis. Armijo (2000) argues that the political elites of developing countries are easily persuaded by transnational financial capital to push its agenda, while individuals who lose are dispersed. But there are reasons why a more representative consensus may emerge.

First, academic discussion continues to clarify many technical issues and to make clear the win-win nature of more complete reform for most if not all participants. Nonetheless, several conclusions that seem clear when these debates are modeled as strategic games are not yet widely

appreciated. This chapter has suggested that some forms of bailing-in the private sector could protect creditors from each other, yet private multinational financial institutions thus far have mainly employed their superior bargaining clout to prevent any restrictions from being placed on them. Still, learning may influence future behavior.

A second reason for optimism has to do with the dynamics of the bargaining process. The basic negotiator's dilemma (Kremenjuk, Sjostedt, and Zartman 2000) can be paraphrased as follows. If a party to a negotiation is too soft, the contract will come through but that party will get very little out of it. If a negotiator is too hard, the contract might fall through. Asian countries are attempting to meet many of the creditor's requirements. If the latter do not make concessions to Asian sensitivities, then the countries will be pushed to adopt measures that in the long-run will improve their bargaining position and leave creditors with a smaller share in any mutual contract than they would have otherwise got. Bargaining theory says that as the disagreement utility associated with the outside option rises for one party, so does its share in the bargain (Muthoo 1999). It is never wise to push too hard. Asian countries in the past have made a strategic use of globalization to develop rapidly; in the future, they will be able to adjust their policies pragmatically to do so again.

An example of the consequences of pushing hard is Asian countries' greater willingness since the financial crisis to adopt some measures that creditors dislike. Thus, the assistant governor of the Malaysian Central Bank, in defending his country's capital controls introduced in September 1998, remarked, "There is no other choice for us, as we cannot continue to wait forever, hoping for the international community to set the framework for regulating short-term capital flows and controlling currency trading" (Hussin, 1999, n.p.). Given that the Asian crisis has pointed to the existence of failures in the private sector of both borrowing and lending countries, one of the preconditions for full capital account convertibility is a reformed and well-functioning international financial architecture (Reddy, 2000).

Third, if there are no substantial reforms to the global financial architecture at the international level, then the likelihood of regional action rises. At the 1999 meeting in Manila of the ten ASEAN members plus Korea, China, and Japan, crucial Asian players began to hammer out a consensus (*Korea Herald*, September 29, 1999). The ASEAN finance ministers took up the theme at their meeting, pledging among other goals to examine "a possible mechanism to monitor capital flows with a view to establishing a regional monitoring system of capital flows in ASEAN," as well as regional protection measures in the event of "a sudden shift in capital flows" (ASEAN 2000, n.p.).

Although strong regional groups such as the North American Free Trade Area (NAFTA) and the European Union have emerged, there has been a relative vacuum in the Asian region-- arising partly due to the weakness of Japan in the 1990s. Links between South and East Asia are weak at present. Asian nations are diverse with varying levels of development. But it is beginning to be recognized that if the three big nations come closer, the others will also. Commercial links between these three have improved in the 1990s. Japan's Sakakibara (2000), in a lecture given in India, remarked that greater Asian regional cooperation --including the South Asian Association for Regional Cooperation (SAARC), ASEAN, and the remaining East Asian countries-- would be desirable, despite past border and regional conflicts. He went on to say that the strengthening of the India-Japanese relationship could serve as a catalyst in inducing China to cooperate with the rest of Asia. Analysts have recognized the usefulness of regional groupings in negotiations in the World Trade Organization (Drysdale 2000), and on the environment. When there are so many issues whose solutions pose collective action problems, the possibility of cooperation rises. Asian countries are also strengthening think tanks, which generate advice that is independent of governments yet understand the local context. These institutions have the potential of bringing countries together. The new information technology has made such activities more feasible. The Asian Policy Forum (APF 2000) is a good example of such initiatives.

Regionalism is not incompatible with globalization. It can even raise the probability of optimal globalization by improving the balance of global power and stability (Ocampo 1999). A consensus may more easily be hammered out at the regional level and then taken to the international forums. The Governor of the Bank of Japan emphasized this point when he talked of the necessity of sending a coherent message from Asia to the various international forums, but at the same time he said, "[W]e should never forget the importance of maintaining the basic philosophy of 'open regionalism' as a major underlying premise to contribute to the stability and development of the world economy" (Hayami 2000, 3). Regionalism also will improve Asia's bargaining power.

Those who feel they are not getting a fair hearing in global groups have more incentive to form their own. There is a perception that aid was arranged much faster for Mexico in 1995 than it was for Asia in 1997. Better regional groupings of Asian nations stimulated by the crisis have several advantages. They can help in the dissemination of standards and information sharing, improve bargaining position, and lead, if not to an Asian Monetary Fund, to its informal analogue. If central banks are willing to lend to each other, it greatly enhances reserves available. At the Chang Mai Asian Development Bank (ADB) meeting in March 2000, it was agreed to do this in times of crisis. Given the speed and complexity of modern financial transactions, no country can ensure stability on its own. Regionalism will develop faster in the future, but without the NIFA it might become "closed" instead of open regionalism.

A fourth reason for optimism assumes rational actors on all sides, perhaps an heroic initial postulate. Being "hard" can lead to the breakdown of a negotiation, yet if the more powerful party in a negotiation is strategically "soft," this tactic can sometimes give huge payoffs. There is a tradition of enlightened policy making as exemplified by the Marshall Plan in the 1950s, or more recently the Brady Plan, which resolved the 1980s debt crisis. In each case, instead of pushing the weaker party to the wall, the stronger party initially yielded a little but

ended up gaining a lot. Hirschman (1998, 41-42), evaluating the negotiations that led to the Marshall Plan, showed that personalities made a big difference. American policymakers accepted disadvantages for the dollar and U.S. exports to Europe, but successfully pushed European countries into a union that served long-term American strategic and economic goals. Hirschman quotes Marjolin, one of the architects of the policy: "This way of acting unselfishly, while apparently absurd, would bear its fruits. In the course of the fifties, Europe's payments to the rest of the world could increasingly be paid without recourse to American aid... Progressively, the discriminatory measures against American foreign trade would be abolished... The sort of wager the Americans had made in the last ten years has therefore been won. In the course of history, it is rare to see long-term and highly uncertain benefits accrue so neatly" (Hirschman 1988, 41-42). Hirschman explicitly notes that the policy attracted unremitting hostility from parts of the U.S. Government and from the IMF because the temporary discrimination against the imports from the United States was seen as going against the principles of multilateralism. Still the policy was pushed through by a section of the American administration, and it ended up benefiting everybody. Softness in some areas could make hardness in others, such as regulations and standards, more acceptable.

If there are such personalities and processes this time also, then ten years from now we may have a thriving global economy and not one divided by "narrow [regional] walls."¹⁵ Such policies also require a sense of community among nations, at present somewhat lacking between advanced industrial and Asian developing countries. But as more contacts, facilitated by new technology, and as commercial interests rise, this fellow feeling could increase. Strategic softening in this context would mean implementing more of the reform proposals that recipient countries are keen on.

The repeated financial crises of the 1990s have already caused setbacks to reforms that creditor countries were keen on, and which were on the verge of being pushed through. Examples

are full convertibility on the capital account, and a consensual agreement on norms for foreign direct investments (MAI). Capital and countries will lose more opportunities if there is not adequate reform of the international financial architecture, the crises continue and walls come up as a consequence.

3.CONCLUSION

Private financial institutions have been lobbying hard to prevent any measures that restrict their freedoms. Although what I have termed the "creditor view" thus far has dominated most of the influential discussions of global monetary and financial reform, this could—and should—change in the future. The rapid recurrence and severity of financial crises has the potential to hurt private finance as well as developing countries. Developing countries do have to restructure and adopt efficient financial practices, but international norms that make capital inflows safer are also necessary to ensure that the new mobility of global capital provides more funds for development, and profits for itself, and ensures a prosperous new century.

Ideas for reform fly thick and fast after each crisis; but most die down without implementation. Many of the ideas being discussed now were in the air after the Mexican crisis of 1994 to 1995. If reforms are not implemented, Asian countries will be forced to go it alone, to experiment with varieties of capital controls, and improve regional cooperation. There will be some loss for capital as well, if the best feasible financial architecture is not built. Debate can keep the sense of urgency alive. We cannot predict when the next crisis will occur, but with each one, our understanding of the causes should deepen. If institutions are reformed accordingly, the probability of future can be lowered.

NOTES

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1. A committee of the Reserve Bank of India (RBI 1997) argued for a phased introduction of capital account convertibility in India. The Report was submitted before the Asian crisis; as of late 2001, its recommendations had not been acted upon.

2. OECD (2000) is an initiative to regulate offshore centers and eliminate tax havens by implementing a common approach to restrain harmful tax practices.

3. This paragraph summarizes news reports and analysis on the East Asian crisis appearing in the Korea Herald from 1998 to 2000. Available at www.koreaherald.co.kr.

4. See analysis and news reports in *China Daily*, a Chinese newspaper available at its website, <http://www.chinadaily.com.cn>.

5. Formal definitions of equilibrium concepts used, and game types such as prisoner's dilemma and coordination games can be found in Binmore (1991).

6. I thank Leslie Elliott Armijo for raising this point. There is evidence that foreign institutional investors do not allocate funds efficiently, and tend to follow each other (Haley 2000; see also Fernandez-Arias and Hausmann in this volume). But on the whole, foreign capital has preferred countries which have bigger markets, more stable regimes, and higher growth (World Bank, 1998).

7. The Bretton Woods institutions have done a difficult job well in that there has been no repeat of the Great Depression, and many countries have had rapid development in this period. See the first and second chapters of this volume for a review of this history.

8. Asia Pacific Economic Cooperation (APEC) worked as such a club in the nineties (see Gilbert, Powell, and Vines 1999).

9. Of the \$112 billion required in the East Asian crisis, bilateral sources provided \$52.5 billion; the IMF itself only \$34.7 billion (Jha and Saggart 2000, 597). If a region were to run out of money in a crisis, the IMF and other multilateral sources could in turn support it.

10. ADBI (2000) quotes John Williamson as identifying three less vulnerable intermediate regimes in his keynote speech. One of them is a crawling peg with soft margins. The relative effectiveness of alternative exchange rate regimes depends on their ability to focus the market expectations that help in limiting exchange rate misalignments. The conference had representatives from thirty-four institutions worldwide.

11. See the contribution by Fernandez-Arias and Hausmann, who call this "original sin." Eichengreen raised a similar point at a seminar at IGIDR in 1999.

12. Aghion, Bachetta and Banerjee (2000) show theoretically that it might not be desirable to implement a tight money policy when investment and production are highly interest sensitive. Stiglitz (1998) collects theoretical and empirical arguments against the interest defense in a currency crisis.

13. East Asia, which has higher expected growth, opportunities, and profitability, received 44 percent of foreign direct investment and 34 percent of aggregate net resources flowing to developing countries in 1997. The comparative figures for South Asia plus Sub-Saharan Africa were only 6 percent of direct investment and 12 percent of aggregate net resource flows (World Bank 1998).

14. Similarly, the United Nations Conference on Trade and Development (UNCTAD) has long pushed the view that special trade concessions are justified for developing countries because of the secular decline in terms of trade in products exported by them.

15. Rabindranath Tagore (1913 [1994]) used the phrase “narrow domestic walls” in his poem the *Gitanjali*, verse 35.

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